Tender Cost Update UK
Q1 2019

TOUGHENING MARKET CONDITIONS WILL LIMIT POTENTIAL FOR TENDER PRICE RISES IN 2019

	2018	2019	2020	2021	2022
NATIONAL	1.5%	1.5%	2.0%	2.5%	3.0%
LONDON	1.0%	1.5%	2.0%	2.5%	3.0%

Overall, 2018 finished in a sombre fashion. Construction output declined in the fourth quarter, with surveys also indicating the situation isn't improving at the start of 2019.

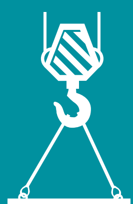
What's more, while the private housing sector was the fastest growing sector in 2018, it ended the year in a weak position. Given total construction growth has been highly dependent on the sector, this is particularly worrying.

On a more positive note, lower oil prices helped reduce material price pressures, providing some support to firms struggling to manage the complex market conditions.

"While fluctuating levels of growth from one quarter to the next has done little for market confidence, it has failed to suppress increases in overall input costs, with labour costs in particular continuing to rise, albeit at a slower rate. We expect this to result in a modest increase in tender prices in 2019, but the continued uncertainty surrounding Brexit and the global economy as a whole will inevitably have a major part to play as we move into the second quarter."

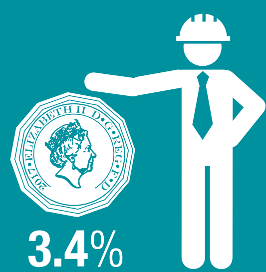
Steven Mason
Managing Director
Mace Cost Consultancy

Construction output rose...



0.7% in 2018, its slowest rate in six years.

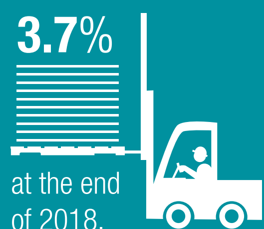
Input inflation has started to ease recently. After peaking earlier in the year, construction earnings growth slowed from 5.7% to...



3.4%

While material price inflation has slipped from 5.7% to...

3.7%



at the end of 2018.

Brexit uncertainty is starting to have a clear detrimental impact on the economy, with...

growth slowing to...
0.2% in Q4

The table gives our current tender price inflation forecast. The figures should be treated as averages and there will always be variations due to procurement methods, project type and local factors.

TENDER PRICE INFLATION FORECAST

After many periods of poor new orders performance, it should come as no surprise that output growth came under pressure in the final quarter of 2018. Total growth in the construction industry was only 0.7% in 2018 and, although this pushed output to a record high, it was also the slowest growth rate since 2012. This slowdown, along with high levels of uncertainty, will have given contractors and sub-contractors limited scope when it came to raising tender prices last year. In many cases, input inflation will have far outstripped tender price increases. A weakening in both earnings growth and material price inflation at the end of the year may have helped combat some of these pressures, but it can be concluded that trading conditions were tough.

Brexit uncertainty means the environment is unlikely to improve in the short-term, and while the easing in both labour and material inflation should continue this year, contractors and sub-contractors still won't find it easy to pass on higher tender prices. We maintain our view that tender price growth will be modest this year, before steadily accelerating through the forecast period, but this is built on the premise that a deal will be reached.

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The first risk to this is a potential extension to Article 50. Parliament not coming to a decision is leading to uncertainty and preventing businesses from investing. An extension may give Parliament the time it needs to make a decision, but it is unlikely to provide the certainty firms require. Indeed, it could increase uncertainty and lead to further delays to projects already put on hold. This, in turn, may force some firms into even more competitive tenders.

The bigger risk to the forecast is a no-deal Brexit. This could dramatically alter both the demand and supply aspects that affect tender prices. From the supply side, such a scenario might generate substantial inflationary pressures, in particular on imported materials. In a no-deal Brexit, the pound is likely to depreciate significantly and, as we saw in the second half of 2016 and throughout 2017, this would push prices higher. There is also the potential for disruption at ports and associated increases in costs due to both tariff and non-tariff barriers. There may also be changes to immigrant labour, with overseas workers potentially choosing to leave the UK. However, given many will be well settled with families in the UK, a mass exodus, at least initially, seems unlikely. There may be some more significant longer term issues; ongoing skills-shortages, the demographic problems with an aging workforce, and fewer migrant workers, might force companies to find technological solutions in the face of much higher labour costs. Despite all of this, there is no guarantee tender prices will rise. We have already seen a large reduction in business investment and investors, developers and other stakeholders could take fright in a no-deal scenario, leading to fewer schemes getting the green light. This might force contractors and sub-contractors into lowballing jobs, dragging down tender prices. Mace still expects a deal of some form to be reached, sooner or later, but it would appear the risks of a no-deal are increasing.

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ECONOMIC CONDITIONS

Uncertainty is undoubtedly having an effect on parts of the economy. A 1.4% reduction in business investment in Q4 was the fourth successive quarterly drop and provides the strongest indicator of companies' reluctance to spend. Trade-wars and a slowing global economy are also likely to be stifling growth, but the main culprit for the economy's weakness is almost certainly Brexit. Low unemployment and rising real wages would often create ideal conditions for a strengthening economy, but both official statistics as well as surveys show broad-based problems

GROWTH

GDP growth of 0.2% in the final quarter of 2018 was slightly below consensus forecasts, far below the third quarter's 0.6%, resulting in growth for the whole year of 1.4%. This capped the end to a topsy-turvy year where, following a snow hit first quarter, the England World Cup run and warm summer contributed to a robust recovery. Even so, total GDP growth in 2018 was the slowest since 2009 as the economy struggled against Brexit headwinds. In the previous five years, growth had averaged 2.2%, showing just how large the drop-off was last year. Economists currently expect growth in 2019 to match 2018, but there are significant downside risks and a no-deal Brexit would likely trigger a lowering of these forecasts.

LABOUR MARKET

In the three months to November 2018, the employment rate rose to a record high, while unemployment, at just 4%, also shows the strength of the labour market. Alongside high numbers of vacancies, the low levels of unemployment are helping to push-up earnings; the annual growth rate of total pay has now stood above 3% for three successive months. This period of nominal earnings growth is the best since the financial crisis, coming as companies struggle to recruit. Surveys, such as the Bank of England Agents' fourth quarter summary of business conditions, suggest a reduction in EU migration is aggravating the problem and many forecasters are anticipating earnings growth of over 3% in 2019.

EXCHANGE RATES

Brexit continues to buffet the pound, with several large movements in exchange rates over the past three months. First, in November and early December 2018, the pound depreciated as it became clear the withdrawal agreement would struggle to get through Parliament. Following this, as traders felt the chances of a delay to Brexit were increasing, the pound appreciated, rallying back to US$1.32. Since then it has fallen back below US$1.30 and, as we near 29 March, further volatility appears inevitable. Nonetheless, unless a no-deal Brexit becomes certain, exchange rate movements are unlikely to noticeably impact material prices.

INFLATION

The substantial reduction in the price of oil in the final quarter of 2018 played a large part in the year-on-year growth rate of CPI slowing to 2.1%. Having started the year at 3% and being 2.7% as recently as August, consumer inflation has eased considerably and is now at its lowest rate in almost two years. On average, forecasters expect inflation to hover around 2% throughout 2019. In the immediate term, the Bank of England predicts it will fall just below 2%, due to the ongoing effect of lower oil prices, before a modest upturn later in the year.

MONETARY POLICY

The interesting outcome from the Bank of England's latest Monetary Policy Committee meeting on 6 February was not the unanimous decision to leave interest rates on hold, but the downgrades made to its forecasts. The stand out change was the reduction in the GDP forecast for 2019, from 1.7% to 1.2%. This is due to Brexit related uncertainty and weaker global economic conditions. As a result of the weakening backdrop, the Bank now expects to increase rates at a slightly slower pace than previously indicated, raising them twice in the next three years instead of three times. There would seem no chance interest rates will move from 0.75% before 29 March and, assuming there is an orderly Brexit, the chances of a rate rise later in the year have diminished.

GLOBAL

While Brexit uncertainty has created problems in the UK, other countries are also currently struggling. Notably Italy, having had two consecutive periods of negative growth, is in a recession. Growth in Germany fell in the third quarter, while household consumption in France was weak, possibly as a result of the 'gilets jaunes' protests. A large slowdown in exports meant that annualised GDP growth in China also took a knock in the fourth quarter, down from 6.5% to 6.4%. Even the US, which enjoyed strong growth earlier in 2018, has seen momentum slow and the government shutdown is also likely to damage first quarter growth. There are a number of factors behind this global slowdown. Some, such as the change in automotive regulations, should prove temporary, whereas others, including the trade-war between the US and China, are likely to be longer lasting. Overall, a slowdown in global growth in 2019 appears likely but most economists are not anticipating an outright recession.

CONSTRUCTION OUTPUT AND ORDERS

A difficult year for construction culminated in output falling 0.3% in the final quarter. This meant that the industry only grew 0.7% in 2018 – its lowest rate in five years. A 2.8% decline in repair and maintenance in Q4 – in large part from private housing as households cut back on big ticket spending – played a big part in dragging down total output. All new work, which excludes repair and maintenance, grew 1.1%, with a strong showing in the infrastructure sector. Over the fourth quarter, infrastructure output rose 1.4%, contributing to the 5.7% yearly increase. A sizeable part of this growth is from megaprojects, such as HS2, and were this to be cancelled, as some have suggested, it would be incredibly damaging for the industry.

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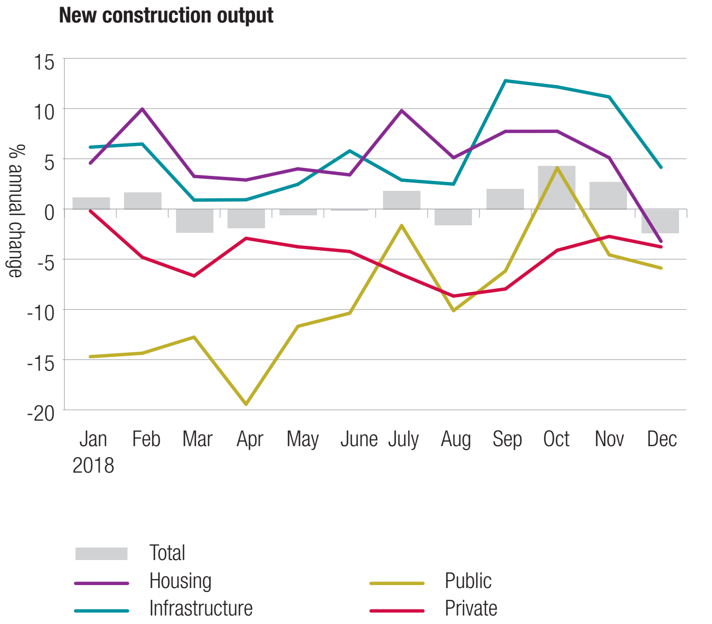
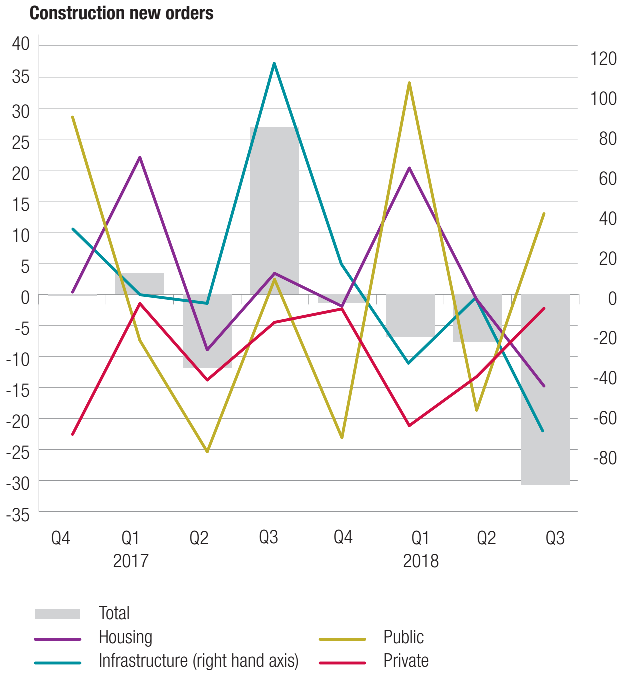
Q4 was also the first quarter since the start of 2017 that saw an increase in output in the private commercial sector. After so many successive falls, it is no surprise that output in the sector was 6% lower in 2018 than 2017. Whether the third quarter of 2018 marks a low point or not, it is difficult to see the sector gaining momentum in the near-term. Rising real wages may provide some support to the retail sector, but much of this will head online rather than to the high street. Similarly, even with a Brexit agreement, there will be a transition period and the office sector will continue to struggle.

The biggest concern from the fourth quarter figures relates to new private housing. Whereas the sector grew 6.1% for the year as a whole, quarter-on-quarter growth in Q4 was just 0.4%. This slowdown came due a 6.8% month-on-month drop in December and, given the volatile nature of the monthly figures, as well as tendency for substantial revisions, it is possible it was just a blip. However, with output in the sector having more than doubled since 2012 and the number of people employed within construction at a record high, it is possible that it is operating close to capacity. Similarly, weak recent new order figures and developers unsure about the impact of Brexit also point to slower growth in 2019.



Housing has been the driving force behind construction growth for a number of years, but had its second weak quarter in a row in Q3 of 2018. Compared to a year ago, private housing was 8.3% down. House prices struggled in 2018 and growth expectations are limited for 2019. This suggests the sector may start to experience more difficulties than seen recently. To finish on a brighter note, two of the smaller sub-sectors enjoyed strong growth in the third quarter. Non-housing public new orders increased 32% quarter on quarter while the ongoing requirements for additional warehouses pushed private industrial up 10%.



After several quarters of falling new orders, there was a small pick-up in Q3. The rise of 3.4% was nowhere near large enough to return the industry to previous levels and new orders remain substantially below their pre-Brexit referendum levels. A year-on-year comparison, where we exclude infrastructure due to the distortion created by HS2 contracts in the third quarter of 2017, shows new orders were down 5.3%. We can expect similar issues in the first quarter of 2019, considering the recent announcement that the £1.5bn Euston Station build contract has been awarded to a joint venture between Mace and Dragados, and the £1bn Old Oak station contract to another joint venture.

Large movements from one quarter to the next means it often makes sense to smooth these figures. As such, comparing a moving four-quarter total (and again excluding infrastructure), we see new orders fall 1.4% against the previous period and almost 5% relative to a year ago. This highlights the ongoing difficulty in all sectors (other than infrastructure) and how uncertainty is affecting the industry. It is also why, although output might not fall in 2019, growth is likely to be slow. Those working on projects which are nearing completion or recently completed, may find fewer potential replacement schemes and this is likely to limit tender price growth.

Private commercial, the area heaviest hit since the referendum, saw solid orders growth of 10.4% in the third quarter. However, on a moving four-quarter basis was still 10% lower than a year ago. In part, poor demand for shops has contributed to the weak commercial figures, but the main reason for the drop off is due businesses worrying about long-term plans and spending less on new offices. That said, Q3 saw a change in this dynamic and offices rebounded. With all this increase coming from London, which already is by far the largest sector, a lot will have to change if, as some hope, Brexit is to lead to a re-balancing of the economy.

MARKET VIEW

January's IHS Markit/CIPS UK Construction PMI indicated that activity was marginally increasing. Within the commercial sector activity fell and there was also a marked slowdown in both the residential and civil sectors. Combined, this left the industry in its weakest position since March 2018. Unsurprisingly, Brexit uncertainty is getting most of the blame for the worsening conditions as clients hold back from making decisions. This is also filtering through to hiring decisions, and employment growth was at its lowest level since immediately after the referendum.

The Q3 RICS Construction and Infrastructure Market Survey headline figure on total workloads also showed activity slowing. While the net balance remains positive, indicating rising output, it is a continuation of the downwards trend that started in 2015. The balance of the private commercial sector falling to almost zero comes as no surprise, but the industrial sector dropping to a similar level suggests the weaker manufacturing sector is cancelling out any benefits from greater demand for warehouses. Respondents were more negative when thinking about the next 12 months than in the last report. The proportion expecting workloads and employment to rise dropped again, with profit margins anticipated to fall.

The Bank of England Agents' fourth quarter summary of business conditions found modest output growth. Housebuilding slowed but there was an increase in work on private rental developments. Similarly, while there was weaker retail and office growth, civil engineering and infrastructure held steady. Delays to projects were causing cash-flow difficulties in supply chains and the report also mentioned a tightening of credit and trade credit insurance availability. Material costs remain a major issue, as does labour shortages, with a lack of EU workers exacerbating this.

In its Q4 State of Trade Survey, the Construction Products Association found that light side manufacturers – those producing goods such as doors and windows – had enjoyed a particularly strong end to the year. A net balance of 50% of light side firms reported a quarterly increase in sales that was higher than at any other point in 2018. For heavy side firms, which cover materials including concrete and steel, a net balance of 27% saw higher sales, which was the same as in the third quarter. However, heavy side firms were much more optimistic than in the previous quarter, with 64% of firms expecting rising sales. In contrast, only 38% of light side firms expected an increase. In spite of the optimism in the survey, in a separate report, the Construction Products Association downgraded their 2019 output forecast to 0.3%

In general, recent surveys offer little in the way of positivity. Most report that output has slowed, with the commercial sector in particular facing problems. Some companies are seeking out the positives in 2019, but optimism is certainly down. It's unlikely that confidence will improve until a decision is made on Brexit.

INPUT COSTS

Labour

In May 2018, regular annual pay growth within construction peaked at 5.7%. Since then, there has been a significant slowdown and, in the most recent figures for November, it was only 3.4%. The fundamentals driving wage growth earlier in the year still exist. In particular, both output and the number of people employed in the construction industry are at record levels. This, combined with the well documented skills shortage, puts employees in a strong bargaining position. Growth of 3.4% is still considerably above the long-run average, despite it representing a shorter term slowdown. The main reason behind the slowdown is likely to be an unwillingness for companies to award large pay increases, given the current political uncertainty, while job hunters are also taking a more cautious approach. If the Brexit negotiations do result in a transitional period and associated greater confidence, it could lead to another bout of strong pay increases.

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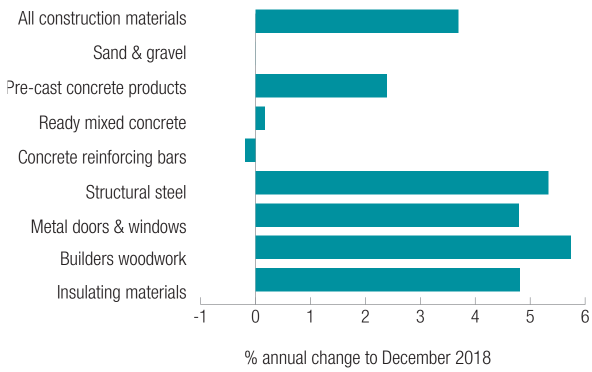
Materials

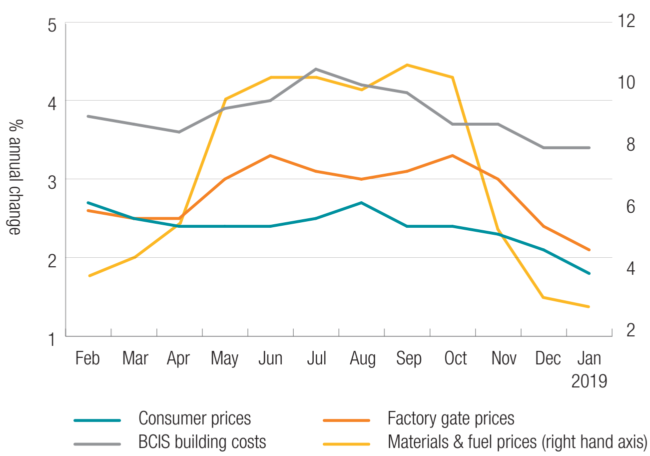
For most of 2018, the inflation rate of the 'all work construction material price index' was stubbornly high, with the pace of growth rising even while consumer inflation slowed. On average, material prices were 4.9% higher in 2018 compared to 2017. However, in the final three months of 2018, this trend ended with the annual growth rate of the index falling from 5.6% to 3.7%. Not only did a 27% drop in the price of Brent Crude Oil contribute to this, but there was also a 0.7% reduction in rebar prices, as well as a 1.7% decline in imported plywood.

Materials prices



The rapid slowdown in inflation isn't likely to continue too far into 2019, partly because oil prices have rebounded. Even so, material prices should still ease further. A large increase in global steel supply in 2018 has led some analysts to forecast lower prices with a slowing global economy, which would also hinder steel and other commodity prices. Nevertheless, a reduction in material inflation rates will only provide some relief to companies hurt by the considerable recent rises.

Inflation Indicators



PACKAGE SPOTLIGHT: TOILET FIT-OUT

Thanks to conversations with Modular Interiors we are able to provide a spotlight on toilet fit-out, offering information on the issues facing this package.

More than many other types of package, the materials used, combined with the bespoke nature of bathroom fit-out, makes comparing one project to the next incredibly difficult. With a substantial proportion of materials imported, exchange rate fluctuations are important, but tend not to be too significant. Italy in particular is a key supplier, while France and China, along with domestic UK goods, also play a part.

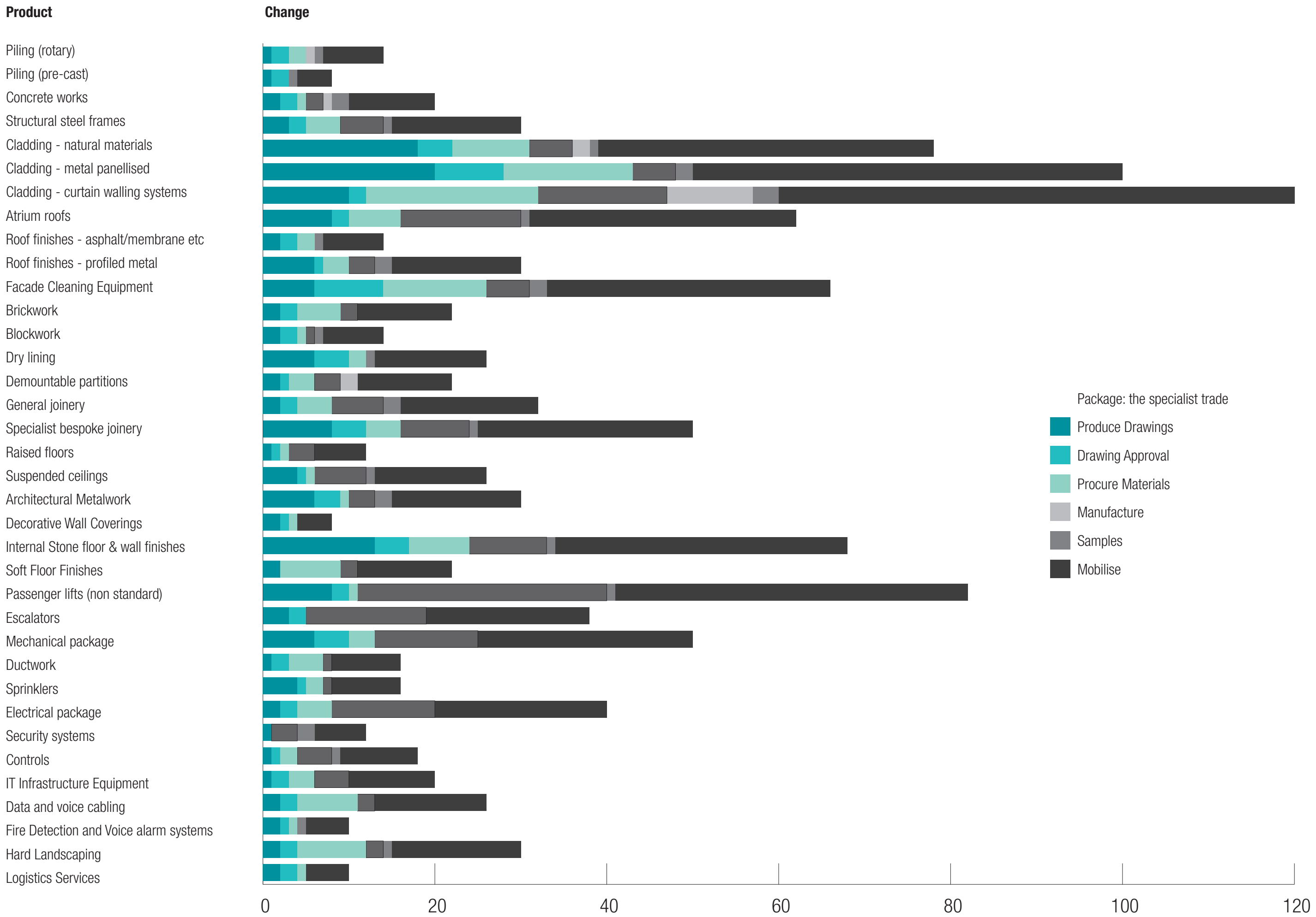
Wage growth over the past five years has been fairly steady, typically around 2-3%, with little difficulty in finding staff. Much of the toilet fit-out workforce is European and, despite uncertainty around Brexit, there is hope that settled workers will remain, avoiding a mass exodus of skilled labour. Employing workers on a piecework basis can encourage efficiency and improve attention, but not all projects are suitable for this method.

As with many other parts of the supply chain, the real factor that affects cost movement is not the materials or labour, which are fairly well known, but other issues instead. This is especially true when much of the work is done in a factory, with mock-ups helping increase certainty. For other packages, it could be that poor drawings or having to rework things increases costs but, in the case for bathroom fit-outs, it is often prolongation and an inconsistent programme. When things work well and as originally planned, a team can move from one stage to the next in a smooth and timely fashion. However, when this doesn't happen, inefficiencies occur which can greatly drive up the cost. In many cases, it can prove more efficient to get onto site at a later date, but prepared to work in an efficient, uniform fashion.

SUPPLY CHAIN FOCUS

"Only two packages are fluctuating this quarter, with pressure on design and manufacturing resources increasing lead times for non-standard passenger lifts for a third successive quarter. Uncertainty over the impact of Brexit on labour and imported materials also remains a concern, not only for this package but across several other packages. Rotary piling lead time has reduced by a week, but the market is predicting this will level off going forward. Across the majority of packages, workload and enquiry levels remain at a consistent level."

Brian Moone
Director of Supply Chain Management at Mace



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